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By bringing government closer to the people, decentralization and greater regional autonomy should make government more responsive and accountable. However the effects of decentralization may not always be so propitious. If carried out without limits imposed for the sake of the national economy and political integration, decentralization may result in economic and political balkanization. Indonesia must take care that decentralization proceeds in a carefully crafted framework that anticipates, and resolves, the problems and issues noted in this paper.

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TRADE AND CITIZENSHIP BARRIERS AND DECENTRALIZATION

BY
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AND
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Introduction

Countries that devolve governmental authority away from the national government and toward local governments usually limit the ability of local governments to interfere with national goals and activities. National goals include national economic policy, harmony among political subdivisions, and protection of the rights of citizenship relating to the mobility of citizens within the nation. While governmental authority may be decentralized, nation-states view their internal economies as integrated, as internal free trade unions, and do not allow regional and local governments to restrict or interfere with internal or international trade. Similarly, citizenship in a nation-state should confer on citizens certain rights to move freely within the country, to take up residence in new places, and to be gainfully employed wherever they may live in the country, whether or not living in their place of birth or origin. Citizenship in the country cannot have much domestic meaning if localities can freely discriminate against travelling or newly resident non-local citizens.

Last year Indonesia adopted two laws concerning decentralization. Law No. 22 relates to the devolution of governmental authority, and Law No. 25 involves fiscal decentralization. The new laws will entail many changes in Indonesia's governance. While there are some implementation details in newly promulgated regulations, it is possible to foresee some serious problems, not adequately addressed in the decentralization laws or regulations, that will arise.

Decentralization of governmental authority and increased local autonomy follow the well-accepted and positive principle of bringing government closer to the people. Decentralization should make governments more efficient, responsive and accountable. Nonetheless, increasing local legislative and executive law making and fiscal authority entails proliferating and differing laws and regulations across kabupatens and regions. Mere dif-

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ferences in laws are not generally matters of concern – except in those areas where laws should be uniform across the country or where local laws interfere with some national interest. No one would claim that a kabupaten or region should have its own foreign policy, nor that they should raise armies and navies. In the important areas of domestic and international trade, and the rights of citizens – which the decentralization laws do not define - as matters of national interest differences in local laws may have large economic and social consequences.

The national economy, domestic and international trade, and the basal equality of citizens wherever they may be in Indonesia are, just as foreign policy or military affairs, matters of national interest. As a nation state, Indonesia and all its islands should comprise an internal free trade union. This is not the place to repeat the arguments about the value of free trade or trade liberalization. But everything that can be said about the benefits of free trade between nations applies to free trade within a nation. Of equal and perhaps greater importance, internal trade barriers and local discriminations against citizens operate to destroy the integrity and solidarity of a nation. In decentralizing, Indonesia must take care that local autonomy strengthens, rather than weakens, nationhood.

With decentralization, there is, however, a substantial risk that local interests, through enactments or through local executive action, may trump national interests. These are areas where the center must retain the authority to control or revise the actions of localities. This can be done either through constitutional provisions or amended decentralization law provisions that deny localities the authority to take action in these areas or that define a reserved right of the central government to invalidate local action inconsistent with national goals and needs. It is difficult, however, to anticipate in advance all of the ways in which local legislative or executive action may interfere with national interests. Furthermore, the very idea of local autonomy argues for greater, rather than lesser, local legislative and executive powers. For these reasons, the central government should, in addition to any other action it might take, reserve to itself the authority to undo local actions whenever they demonstrably injure clear national interests.

Law No. 22 on Decentralization has provisions defining what governance authorities are given to regional authorities and what are retained by the central government. Articles 7 (1) and 7 (2), for example, outlines which areas are to remain as matters of 'national concern' and therefore not to be devolved to the regions. These include international politics, defence, justice, monetary and fiscal policy, religion, national planning, national macroeconomic development, national administration, human resource development, exploitation of natural resources, strategic high technology, conservation and national standards. Unfortunately, internal trade is not explicitly mentioned in either of these articles (nor even foreign trade).

Internal trade and local treatment of non-local citizens are matters of national concern, and the national government can articulate governance policies in these areas that regional governments must carry out and enforce.[1] As yet, the national government has not

[1] A potentially important policy instrument to protect the internal trade and competition environment from decentralisation pressures is the government regulation (peraturan pemerintah) 25/1000 which delineates

articulated such policies. In the absence of central government rules or guidelines, there are signs that some local governments are taking the autonomy initiative and are undertaking actions inimical to trade and other national interests that may be difficult to undo. The closure of the Newmount mine in Sulawesi over a local tax dispute is a clear example. Further examples appear in recent newspaper reports. One alleged that local authorities in Semarang refused to allow a shipment of sugar to unload on the grounds that central Java was already sufficiently supplied with sugar. Another report alleged that regions might seek to impose license taxes on vehicles licensed in other regions. Finally, there is a recent report that Lampung has created a long list of tariffs on local products destined for other parts of Indonesia. *Peraturan daerah* from the Provincial government (Nomor 6 Tahun 2000 - *Retribusi Izin Komodoti Keluar Propinsi Lampung*) imposes a tax or 'license fee', of between Rp. 2/kg. and Rp. 150,000 /kg., on 180 commodities exported from the province. In addition, even products not of Lampung origin will also be taxed as long as there is no proof of origin.

Fortunately, in addition to this accumulating evidence, the local autonomy experience of other countries makes it possible to predict with accuracy the specific kinds of problems likely to arise. For example, as a federal state[2], the United States has a well-developed law, or jurisprudence, regarding local interference with domestic trade and regarding local discriminations against citizens.[3] The same is true of countries such as Australia. Using such sources as well as Indonesian evidence, the following brief review summarizes major domestic trade and citizenship issues that Indonesia is likely to face under decentralization. It also proposes various free trade and equality of citizenship rules that Indonesia may wish to consider adopting. Of one thing Indonesia may be certain, however, is that the kinds of problems described below will arise, and that the country needs to have some means of dealing with them.

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the responsibilities between central and local government. At the time of writing DEPPERINDAG was working to ensure that the ministry's relevant section in this regulation has the necessary detail to provide that protection.

[2] For the purposes of this article, it is irrelevant that Indonesia is not a federal state. Federalism is a name given to a certain arrangement of governmental powers as between the center and the periphery. In choosing to decentralize governmental authority and power, Indonesia is empowering local governmental institutions to act, over a range of matters, independently of the center. That is the commonality between federal state arrangements and Indonesia's decentralization, and federal state experience is therefore relevant to Indonesia.

[3] For the most part, the Unites States treats these issues as matters of constitutional law. Indeed, they are, for they ultimately deal with the very constitution of the state, with power arrangements between governments, with the separation of powers between governments in the nation, and with the rights of citizens. All these matters fall under what is called "dormant Commerce Clause" jurisprudence. The Supreme Court of the United States, and lower federal courts, have taken on the responsibility of insuring that the union of states remains a free trade union and that citizens of one state in the United States are treated with equality and fairness when they undertake business or sojourns in other states.

I

Competition and Trade in a Decentralized Economy

Economic efficiency and growth, and consumer benefits are major reasons why there should be free trade and free movement of citizens between localities. Free trade and the economic activity associated with free movement increase the size of markets and insure that competitive advantages found in one locality generate benefits for consumers in all localities. Free trade and free movement in this sense is a form of competition policy and aims at protecting and facilitating the competition process because of the economic gains conferred.

Economics is not the only reason that nations prize internal free trade and free movement. Trade and citizenship barriers not only undermine national economic integrity, but also limit political integration. Economic interests allied with ethnocentrism can, if not held in check or disciplined for larger goals, lead to rampant hostility and economic and political fragmentation. Free trade and free movement, by contrast, contribute to nation-building. Local tariffs and local protectionist actions, as well as discriminations against non-local citizens, divide localities and citizens from one another and encourage the development of insider-outsider mentalities. Local discriminatory and protectionist actions stimulate other localities to undertake defensive countermeasures and retaliations, all in a process of action and reaction that can spiral out of control. As Indonesia is an archipelagic state and as its islands, regions, and places within regions, are territorially associated with particular ethnic groups, it has a high potential for this kind of separatist, divisive, and potentially volatile local politics.

Under decentralization, without some check, localities are likely to discriminate against domestic trade from other regions, or to favor local traders over outsiders, or to seek to impose costs on outsiders. Local interests will pressure local authorities to enact laws that protect them from non-local competition or that handicap outside competition. Similarly, because they are not accountable to outsiders and do not represent them, when local governments need money, they are likely to tax outsiders – or tax insiders in such ways that the costs fall on outsiders (*e.g.*, the Lampung export tariff).

In view of such likelihoods, and to insure economic and political integration, it is essential that Indonesia have a basic rule that localities may not discriminate against interregional trade. Local units of government should treat all trade, whether originating within their boundaries or outside, evenhandedly. Tariffs, exceptional licensing requirements, and other regulations targeting interlocal trade make it more costly, destroy competitive advantages of production, and increase costs to consumers. A second, related rule is that even where localities do not expressly target and discriminate against interregional commerce, they should not be permitted to adopt laws or regulations that place significant and unnecessary burdens on such trade. Unnecessary trade burdens are trade-inhibiting; and trade is to be encouraged rather than discouraged.

Regions, of course, must have the authority to enact health, welfare, and safety laws, but

when such laws damage interregional trade, the benefits gained from them should justify the burden placed on trade. Suppose, for example, that in the interests of traffic safety, a region adopted a law that required all trucks to have eight rear stoplights. While there might be incremental safety benefits deriving from this law, other regions might adopt dissimilar laws. In that case, trucks driving from one region to another would be subjected to different safety requirements and the unjustified costs of having to change equipment at each border. The costs would be unjustified in the sense that the incremental safety benefits of eight, as opposed to six or four rear stoplights are marginal at best. Furthermore such a law could mask a discriminatory purpose: for example, suppose there is a local trucking company whose trucks are already equipped with eight rear lights. Trucks with fewer lights are disadvantaged, and a law seemingly neutral on its face may actually intend to advantage one competitor over others. Such laws should not stand.

Tax Barriers to Inter-regional Trade Ensuring free flows of goods and services within the domestic economy represents an important component of national competition policy. This is particularly the case for the archipelagic and essentially agrarian country that Indonesia comprises. Some of the advantages of national union are lost when localities can impose tariffs or tax exports as though they were independent sovereigns. If trade flows are not free, what, from the point of view of trade, are the advantages of nationhood? Permitting localities to impose such taxes will not secure trader loyalty to the center. Furthermore, as such taxes and levies will vary across localities, there will be trade and competition distortions dependent on the cumulative size of the exactions. A trader may find that it can compete successfully in one area because there are no exactions and unable to compete in other areas because the exactions make trading unprofitable.

This is particularly true for farmers and other small-scale agricultural producers, especially those who transport their produce over long distances. Long distances imply more exactions, and in order to attempt to remain competitive, framers and small-scale producers having to pay such additional costs may have to absorb them rather than attempt to pass them on to consumers. Prior to enactment of Law 18/1997, which removed many tax distortions to domestic trade, farmers and traders were forced to pay various charges and fees on the side of the road or at key access points during transport. Those travelling longer distances lost a greater percentage of the wholesale price. With passage of Law 18/1997, provincial and kabupaten authorities were no longer permitted to tax agricultural products involved in inter-regional trade. As a result, the wedge between farmgate and market prices was reduced, and farmers were able to command a greater share of final wholesale prices (Syaikhu et. al. 1999). This raised farmer incomes and stimulated regional trade and production activities

Recent evidence[4] suggests that there remain various forms of taxes on domestic trade. Further, the same studies show that, and thatregional government commitment regional to the implementation, enforcement and socialization of Law 18/1997 varies significantly from province to province and kabupaten to kabupaten. Tax type distortions to trade con-

[4] Persepsi Daerah (1999), Ray and Darma (2000) and CESS/TAF (2000).

tinue to be more prevalent in the outer regions and at the more disaggregated levels of government (*i.e.*, the village level). (See box 1 for a case study on domestic trade distortions in South Sulawesi.)

Box 1.
Barriers to Inter-regional Trade
Case Study: South Sulawesi

Regarding the imposition of both legal and illegal charges on domestic trade South Sulawesi has, and continues to be a problem province despite the introduction of Law 18/1997. Studies by Darma (1999) and CESS/TAF (2000), as well as recent field work by one of the authors (Ray), show that the incidence of informal charges on domestic trade is again on the increase, particularly over the past 6-12 months.

This is particularly the case at weigh stations. After Law 18/1997 became effective, weigh stations throughout the province were closed, but in the past 12 months have become active again. A major reason for the establishment of weigh stations throughout this and other provinces is to prevent road damage from overloaded trucks. Ironically, their presence ensures the opposite result. This is because the weigh bridges are being openly misused by Department of Transport officers to extract illegal payments from drivers. To compensate for these and other illegal payments (e.g., those required by the police), driver and traders must overload to ensure adequate margins. When there are no weigh bridges on the planned route, drivers tend to reduce their load.

However, this is rarely so. For a province with a relatively small population, South Sulawesi has a large number of weigh stations. For example, on the road from the northern part of the province, Kabupaten Luwu Utara, to Makassar (the capital in the south) there are 6 weigh stations, including two that are less than 25 km apart (i.e. in the town of Datae in the Kabupaten Sidrap and in Lumpue near the port of Pare-Pare). The amount each truck must pay is between Rp 5,000 - 20,000, depending on the amount of excess weight.

Maximum capacities are determined by the provincial Department of Transport office in such a way to ensure that all product transport vehicles are overweight. For example, six wheeled vehicles with a 6-7 ton capacity are allowed a 4-ton limit, 12-13 ton capacity vehicles are only allowed an 8 ton limit. All drivers surveyed insist that transporting at, or under, the maximum tonnage allowed is extremely uneconomic. According to local regulations, any transport vehicle found at a weigh station to be overweight is required to be unloaded, however according to local drivers this never happens.

There are many other examples of illegal taxes and charges on the movement of agricultural goods within South Sulawesi. Interviews with farmers, truck drivers, traders and shippers reveal that these informal charges are collected by officers from a range of authorities including the air/sea police, customs, port authorities, the forestry department, local police.

For example, from the rice producing area of Sidrap to the port town of Pare-Pare (approximately one hour by road) there are usually 2 police posts where payments must be made. Further payment to the police is required for entry into the port of Pare-Pare. Each post requires payment of between Rp 3000-5000 (although some drivers complain that demands are often for larger amounts). From Sidrap to the provincial capital, Makassar (approximately 4 hours to the south) there are seven police posts, as well as three weigh bridges. Other drivers and traders interviewed were transporting cattle from Bone (on the east coast of the peninsula) to Makassar and reported that the 5-hour trip might involve the payment of around 20 illegal charges. Traders typically estimate the largest expected loss from these charges and pass these losses on to farmers in the form of lower prices.

Source: Field trip to South Sulawesi, April 2000: David Ray and Rahim Darma, see Ray and Darma (2000)

Local governments are also becoming inventive in finding ways to tax trade. The 'third party contributions' facility (or SPK), for example, is rapidly becoming a *de facto* tax on

trade in a number of outer provinces. This facility requires local business to provide 'voluntary' payments to local government. The SPK operates as a tax, but it is not recorded as such within government accounts. This is because it is meant to be a 'contribution' or 'gift' from the community to local authorities. Third party contributions are classed as 'other sources of income', and are therefore not affected by the reform measures contained in Law no. 18 /1997.

Since the implementation of Law no. 18/1997, provincial and kabupaten governments have used third party contributions to increase revenues, or at least to offset the expected fiscal losses associated with the removal of the various kinds of trade taxes and levies. Examples of the misuse of SPK facility can be found, amongst other places, in the province of Nusa Tenggara Barat, where tobacco producers are obliged to 'volunteer' Rp. 80 to local coffers for every kilogram produced. Similarly, in the cattle market in Mataram, Lombok, traders must pay SPK Rp 2000 for each head of cattle traded.

Devices ranging from subtle pressure to explicit threats of punitive action serve to collect this levy. Forced "voluntary contributions' are neither voluntary nor contributions. They are taxes, plain and simple, and should be acknowledged as such. As taxes, they must be examined for their trade distorting and inhibiting effects. Where permitted, as taxes on trade, they should be subjected to tests of transparency and evenhandedness.

Local economic protectionism. Discrimination against out-of-region businesses should be presumptively illegal. An anti-discrimination rule would require that, in terms of their trade, regions should treat out-of-region businesses evenhandedly with in-region businesses. Throughout Indonesia, there are examples of drivers and traders having to pay what amounts to a tariff to enter a province. Traders bringing in furniture from East Kalimantan into South Sulawesi through the port of Pare-Pare must pay an informal landing fee of Rp 5000 per unit (in addition to a variety of other charges within the port, along the roads and also at weigh stations). According to traders and drivers transporting goods in the opposite direction there are no equivalent informal landing charges in East Kalimantan ports[7].

Monopsonies as Protection. Local governments, as has often occurred in the past, may seek to support local companies, traders or government cooperatives (KUDs) by bestowing upon them monopsony rights to buy a particular commodity produced withinthe locality. Such policies typically depress farmgate prices, while substantially increasing the trading margin for the licensed monopsonist (*e.g.*, the citrus and lipstick-oil nut trade in West Kalimantan - see below). As for KUDs, they are often not genuine cooperative enterprises, existing as a cooperative only on paper, and, economically speaking, existing only to but provide rent seeking opportunities for local government officials or their designees.[8] The net effect of these government created monopsonies is lower farmer in-

[6] Fieldwork carried out by David Ray and Lukman Muslimin, Lombok, NTB June 2000.
[7] Fieldwork carried out by David Ray and Rahim Darma, Pare-Pare South Sulawesi April 2000.
[8] Persepsi Daerah (1999) reports that until recently Farmers in Ende, East Nussa Tenggara, were required to sell their produce to KUD cooperatives and were forbidden to deal directly with traders. Only the KUDs could sell to traders. The problem was that there were no real active KUDs. There were however, KUD local government officers who were able to command a rent from their monoposony position.

comes, higher consumer prices, and if the incentive environment is sufficiently distorted, the potential collapse of the local industry.

A well known example of how such local government action can favor particular businesses and traders over others, at high social cost, involves oranges. In 1991, the Governor of West Kalimantan issued a decree that, in effect, required all oranges destined for inter-island trade to be sold to PT Bima Citra Mandiri The effects on trade were disastrous; farm prices for oranges dropped substantially and exports fell by 63%. Consumers off Kalimantan were also worse off, either because of the decrease in exports or because the monopsony buyer was also a monopoly seller of West Kalimantan oranges.

Monopsony privileges are anti-competitive and trade distorting and discriminate against other potential buyers. As the above examples suggest, localities should not, through regulation of trade or commerce, protect in-region economic interests from out-of-region competition. Laws that expressly single out interregional trade for disparate and negative treatment should be unacceptable nationally.[11]

There may be an exception to this rule favoring commerce where the region can demonstrate that: 1) interregional commerce is the source of the problem that the region seeks to correct; and 2) that there are no nondiscriminatory ways available to protect local interests.[12] For example, suppose that a region can prove that a natural fertilizer product imported into the region from another region contains a harmful parasite. In such a case, even though a ban on the harmful fertilizer may help local fertilizer producers, the ban targets the exact problem and does not have a protectionist motive.

For this reason, regions should be able to enact quarantines singling out interregional trade in specific goods for special treatment, or even banning trade in them altogether, if the trade is the source of a real and significant harm that cannot be remedied otherwise.[13] Sometimes, however, laws adopted for ostensible so-called "police power" reasons actually mask efforts to injure out-of-region trade or traders. While regions should be able to enact laws that protect or further health, safety, and social welfare interests, they should seek to do so in ways that do not discriminate against or burden interregional commerce. Furthermore, there are often ways to advance health, safety, and welfare interests without injuring trade or commerce. Where possible, there should be every effort to do so.

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[10] A company owned by a Suharto family member

[11] *Wyoming v. Oklahoma,* 502 U.8. 437 (1992) (Oklahoma statute requiring in-region coal-fired power-generating plants to purchase from inregion producers ten percent of coal used to produce power invalid on its face).

[12] *Philadelphia v. New Jersey.* 437 U.S. 617 (1978) (ban on disposal, within-region, of waste originating out-of-region, invalid; no showing of any reason, apart from origin, for treating the kinds of waste differently); *Chemical Waste Management v. Hunt.* 504 U .8. 334 (1992) (fee imposed on hazardous waste originating out-of-region, but not in-region, invalid); *Fort Gratiot Sanitary Landfill v. Michigan Dept. of Natural Resources.* 504 U.S. 353 (1992) (region law in effect permitting counties to ban in-county disposal of out-of-county waste invalid).

[13] *Maine v. Taylor.* 477 U.S. 131 (1986) (region law banning importation of out-of-region baitfish upheld because of danger they posed to native species).

***Price Controls*.** Provincial and district level governments should be prohibited from imposing price controls on goods sold or produced within the region and exported elsewhere. A local government may wish to establish a minimum price for a particular product when the production and inter-regional sale of that product is thought to be critical for the region's economic health. The aim of a minimum price law is to ensure that local producers get sufficient returns to stay in business. Such laws however destroy the competitive advantage of out-of-region producers who can produce out-of-region and sell in-region at lower prices. The effect of such a minimum price law would be to protect less efficient local producers from more efficient out-of-region producers. While canceling a benefit of free trade, it also injures local consumers, who must pay higher prices.

In other circumstances a local government may wish to impose maximum price controls for a particular good produced and sold within the region. Such controls are often designed to ensure low cost access to inputs for local downstream producers. This disadvantages out-of-region producers who must pay full market price for similar inputs. It also disadvantages local producers who cannot get access to out-of-region markets where prices offered by buyers are higher than local price ceilings. It also means that producers must reconcile rising production costs against fixed revenues.[14]

***Quantitative restrictions on inter-regional trade*.** Provincial and district level governments should be prohibited from imposing quantitative restrictions on goods and commodities involved in inter- and intraregional trade. Some local governments, such as the provincial government in Nusa Tenggara Barat fix the number, and destination, of livestock for shipment from producing areas.[15] This quota policy is designed primarily to preserve cattle resources in producing areas. It is a curious policy, for it is unlikely that cattle growers faced with increasing demand would sell all of their cattle, leaving none remaining. The natural response to increased demand would be to raise prices and increase the size of the herds. Eventually, the market would reach a natural equilibrium. The effects of the policy, however, are to make cattle cheaper in the exporting region, dearer in importing regions, and to advantage traders that can somehow evade the quota. Evidence to date suggests that this policy does not limit shipments, but simply increases bureaucratic costs, and creates new rent-seeking opportunities for local officials who control quota rights. It also creates new 'secondary' markets where a quota rights holder, who may not even raise cattle, may sell the valuable quota property right.

Nonapparent discrimination. Some regional actions that, superficially, appear not to dis-

[14] A particularly exploitive example involves maximum price controls on agricultural commodities set by a trade board, made up of local traders, on behalf of the local government. (Flores, Persepsi Daerah 1999). This arrangement seriously disadvantages local farmers.

[15] Every year Provincial office of Livestock Services (Dinas Peternakan) announces the quantitative restrictions on livestock involved in inter-island trade originating from NTB. These restrictions also apply to the amount, type and weight of cattle that can be slaughtered. The most recent announcement was in December 1999 which restricted the number of cattle that can be extorted from NTB (or slaughtered) to 11500, down from 23000 the year before. *See Surat Keputusan Kepala Dinas Peternakan Propinsi NTB Nomor: 1348a/XII/UT/1999 and Nomor: 188.4/1835/UT/XII/98* (Fieldwork carreid out by David Ray, Gary Goodpaster and Lukman Muslimin, West Nusa Tenggara July 2000).

criminate against interregional trade may nonetheless implicate national economic concerns. This would occur, for instance, when a local government authorized a ban on both in-region and out-of-region commerce to a locality. The simple fact that a law proscribes both local and interregional commerce, and thus appears to treat them evenhandedly, does not mean it is necessarily valid. The effect of such a law is to limit trade and thus injure the national economy. While such bans do not single out interregional trade or commerce for special treatment, they clearly burden it nonetheless. In addition, such bans could disguise efforts to circumvent policies aimed at national economic union.

Government Procurement. Issuance of government tenders and contracts is an area where policy makers can play a direct role in ensuring open and competitive markets for all players. Conversely, they could use this authority to e discriminate against certain parties. In exercising public works projects powers, there is a likelihood that local authorities will discriminate in favor of local suppliers and contractors, at the expense of the competitors from Jakarta and other cities and regions.[17] Key criteria for determining winning bids for government tenders should be a combination of experience, technical capability, and price. However, as outlined in Presidential Decree 18/2000 on government procurement, a firm's size and place of domicile are key factors determining who can tender for projects. For small to medium sized projects, the decree requires government offices issuing tenders to give 'priority' to local companies. Moreover, outside firms winning bids over a certain size are obliged to employ or work together with local firms. Such stipulations clearly restrict competition for procurement by disadvantaging large and non-local firms. (See Box 2 for a case study on consultants in government procurement).

Box 2
Discrimination against outsiders
Case Study: Consultants and Government Procurement

The consultancy industry in Indonesia is very centralized. Of the 3500 consultants registered with INDKINDO (the Indonesian National Consultants association), 1000 are domiciled in Jakarta. Until recently most projects were tendered by the central government, or branches of the central government in the regions. Given their larger size, their more sophisticated techniques and their more skilled and experienced personnel, Jakarta consultancy firms were able to dominate the available projects.

In response to complaints from regionally based consultants, and also as part of the decentralization process in general, various measures have been taken by government to ensure local participation in projects. Presidential decree (*Keppres*) no. 16/1994 on government procurement established a classification system for consultants, suppliers and contractors, whereby firms could only tender for projects consistent with their size. Large firms (Class C) were limited to projects in excess of Rp 100 million, medium sized firms (Class B) Rp 500 - 100 million, whilst only small firms were allowed to tender for projects less than Rp 50 million (Class A). More importantly only local firms from the target area for the project were to compete in the Class A category.

Earlier this year, this decree was updated by Keppres 18/2000 resulting in the following classification:

[17] *'Daerah jangan monopoli proyek'* Bisnis Indonesia *Tuesday 4th March 2000.*

Table 1.
Limitations to access government procurement (Rp million) by firm size

	Class A Small Firms/ Cooperatives	Class B Medium Sized Firms	Class C Large Firms
Consultants	< 200	200 < B < 1,000	> 1000
Goods suppliers	< 500	500 < B < 4,000	> 4000
Contractors	< 1,000	1,000 < B < 10,000	> 10,000

Two further restrictions to government procurement are stipulated in the presidential decree.

1. Large firms supplying projects over a certain Rp amount are required to work together with local small to medium sized enterprises or cooperatives. This stipulation applies for contractor projects in excess of Rp 25,000 million, good suppliers in excess of Rp 10,000 and consultant projects in excess of Rp 2,000 million (Paragraph 10)

2. For all projects classified as Class A or B, priority should be given to local small to medium sized enterprises or cooperatives (Paragraph 10)

These two accompanying regulations, coupled with the limitations outlined in the above matrix, clearly restrict the competitive environment for firms bidding for government procurement. The criteria for winning government tenders should be not be influenced by firm size nor place of domicile. Rather technical capabilities, experience and price should be the main criteria.

Jakarta based consultant are concerned that the stipulation within paragraph 10 of *Keppres* 18 to prioritize local firms will embolden local governments to unfairly discriminate against bids from non-local companies[18]. What is not made clear in this presidential decree is how local firms are to be prioritized.

What is also not clear is how local consultants are to be brought into projects managed by non-local firms. There are already a number of cases where Jakarta based firms within INKINDO have protested having to use poorly local skilled and equipped consultants. With most tendered projects now devolved to the provincial and kabupaten level there are also concerns about the technical capabilities of local government to effectively and transparently manage the tendering process and competently assess the technical aspects of bids.

Source: Fieldwork and interviews May 2000, David Ray

Requiring in-region processing of exports. In order to generate business and employment within their borders, regions may sometimes require that products harvested within the region also be processed or partly processed within the region before export. Until recently, South Sulawesi required that cocoa beans and cashew nuts be processed within the region. This regulation had a deleterious trade effect because there is an export market for unprocessed beans and nuts. The regulation also favored local processors by protecting them from competing out-of-region processors. Finally, it injured local farmers by limiting the market for their products. Limiting the demand means that local processors

[18] It is interesting to note that some provincial governments such as that is West Kalimantan have already issued instructions to their public works and other departments tendering projects to prioritize local firms.

could pay less for a given amount of supply. Because such protectionist actions limit trade and preclude competition, they are injurious to the national, as well as local, economy, and should be invalid.[19]

Regional allocation of markets (rayonisasi). Provincial and district level governments should be prohibited from licensing or sanctioning the division of marketing/production territories and/or the allocation of markets for goods and services on behalf of local and non-local companies and individuals. A local government may seek to support a local firm or individual by allocating to it marketing areas that competitors cannot access. This disadvantages local consumers by limiting choice. Moreover, the lack of competition within the allocated sector often translates into higher consumer prices. The allocation also disadvantages non-local suppliers who wish to gain access to these markets

A well-known example of rayonisasi involves tea processing. In West Java, the Nusamba Company built four tea-processing factories even though there was already excess tea-processing capacity there. To secure fresh tea leaves, Nusamba persuaded the Governor of West Java to instruct Bupatis to "rationalize" the tea market by allocating sales of tea leaves to certain factories (Perspepsi Daerah 1999). The instruction was clearly protectionist for a local interest and advantaged Nusamba over its competitors, whether local or more distant. At the same time, it allowed Nusamba to act as a monopsonist, permitting it to determine prices to tea leaf sellers.

Other examples of *rayonisasi* can be found throughout Indonesia. In the West Nusa Tenggara island of Sumbawa, farmers are limited to raising/producing only one type of cow (Bali Sapi). This in turn severely limits market opportunities for local cattle producers. Meanwhile in the smaller neighboring island of Lombok, cattle farmers have full freedom and flexibility in production, and as a result are more successful[20]. Another example of *rayonisasi* can be found in the cotton producing areas of Bulukumba, South Sulawesi. One monopsonist, a local factory, controlled this industry for a long time. Recently, there have been a number of new entrants. However each factory buys exclusively from particular production areas, leaving farmers with no choice but to sell to their respective monopsony buyer.[21]

Forced partnership programs (kemitraan). Provincial and district level governments should be prohibited from enforcing or coercing firms and/or individuals into partnership programs (kemitraan). Involvement in such programs must be purely voluntary. Provincial and district government authorities, in particular the Estate Crop Services offices, sometimes actively encourage the formation of partnership programs between small-scale agricultural producers and large firms. The expectation from these programs is that small farmers will be empowered from their relationship with large firms. Evidence to date suggests that many of these programs unfairly tie the small farmers to selling their output to the larger partner firm, often at unfavorable prices.

[19] *Pike v. Bruce Church, Inc.*, 397 U.S. 137 (1970).
[20] Fieldwork carried out by David Ray, Gary Goodpaster and Lukman Muslimin, Nusa Tenggara Barat July 2000.
[21] Ray and Darma 2000.

Local benefits not provided to outsiders. While regions should not regulate interregional commerce to advance local interests over outside interests, local legislatures may nonetheless wish to provide local interests with some benefits that may give them a competitive advantage over outsiders. *Example*: Suppose a region wishes to advance small businesses by subsidizing them or providing them with useful services. Given the tie between local governments and local citizens, localities should be able to subsidize in-region producers and residents while not providing similar subsidies to nonresidents.[22] In other words, a region should be able to benefit its residents by providing them assistance, but not by harming non-residents. While there is a favoring of local residents over outsiders, governments of localities that aim at serving their own residents should be able to provide the residents with some services not given to everyone at large. A government's willingness to use its revenues to advantage its citizens over outsiders is not a negative thing, and, if they wish, other regions may act similarly.

Reciprocity requirements. Reciprocity rules need close examination for their effects on trade. Regions could enact regulations that condition the sale of imported goods on the exporting region's agreement to allow sale of the importing region's similar product in the exporting region. While such requirements seem merely to enforce free and equal trade, they may actually interfere with commerce and should be invalid. *Examples:* If region *A,* for proper health or safety reasons, bars importation of *unsafe* milk from region *B,* region *B* cannot in turn bar importation of *safe* milk from region *A* in order to force region *A* to accept its milk.[23]

Regional legislation having extraterritorial effect. Legislation has extraterritorial effect when it regulates the activities of parties outside of the geographical region governed by the legislation, a result akin to legislating in a sister region. On occasion, a region may seek to protect or advance its own economy by extending its laws to outsiders in a way that protects in-region businesses from out-of-region competition. Regional laws having this kind of extraterritorial effect should be invalid. *Example:* By statute, a region establishes a minimum price for a product the in-region production and interregional sale of which is critical to the region's economic health. The aim of a minimum price law is to ensure that producers get a sufficient return to stay in business. When the region seeks to apply such minimum price law to out-of-region producers who wish to sell in-region, however, it aims at interregional commerce or trade. It also destroys any competitive advantage that the outsider's willingness to accept a lower price confers, thus protecting in-region producers from outside competition. Similarly, a regional law regulating acquisition of shares in corporations having at least ten percent of their capital and surplus in-region should be illegal as an attempt to regulate nonresident corporations.[24]

Legislation aimed at an in-region market, but having interregional effects. Laws applicable solely within a region may have effects on interregional commerce. *Example*: A law requiring that in-region producers receive a minimum price for their goods effec-

[22] *New Energy Co. of lndiana v. Limbach,* 486 U.S. 269 (1988).
[23] *Great Atlantic & Pacific Tea Co., lnc. v. Cottrell.* 424 U.S. 366 (1976).
[24] *Edgar v. MITE Corp.,* 457 U.S. 624 (1982).

tively requires out-of-region purchasers to pay that price. Such laws, however, apply only in-region, are not aimed at interregional commerce, treat it equally rather than discriminate against it, and should be valid.[25]

Transportation regulation. Certain aspects of interregional trade might demand a uniform rule and consequently exclusive legislation by the national DPR, but other aspects or matters, because of their local diversity, might, in the absence of national law, call for local regulation. Safety is one such matter, and this is usually of concern regarding transportation. When a regional transportation safety regulation seriously conflicts with other regions' standards and imposes a heavy burden on trade, the regulation should require a strong justification, and there should be less deference given to the regional legislative judgment about the need for the safety regulation. Suppose, for example, that a region asserted control over railroads and railroad rights of way in the region and adopted a law that required a wider gauge railroad track than that of an adjoining region. The practical effect of a law would be to stop out-of-region trains at the regional border since they could not utilize the wider gauge tacks.

One area where transport regulations are used to discriminate against outsiders is the use of licenses to use roads within a certain region. The *Izin Trayek* rule in South Sulawesi for example, requires all transport trucks to carry these licenses. Currently there are three different licenses required: *i.e.*, for inter- and intra-provincial transport and for entry into regencies (kecamatan). The first two forms of *Izin Trayek* are issued at the provincial level in accordance with Gubernatorial Decree (keputusan) No. 10 1996. Local government issues the last.. Trucks not carrying licenses are typically fined Rp 35,000. As these licenses are not available outside of South Sulawesi, this regulation discriminates against trucks from outside areas, particularly those from other provinces.[26]

Regions as market entrepreneurs; government-owned businesses. While regions may often seek to regulate markets, regions can also enter markets as participants, *e.g.*, as traders or manufacturers. As Indonesian decentralization law authorizes regions and localities to create government-owned enterprises, this is a likelihood in Indonesia. When the region acts purely as a proprietor or entrepreneur competing with other entrepreneurs, and not as a regulator, it should be treated just as any private party would be treated. Just as a private entrepreneur may decide which parties to deal with, a region acting as entrepreneur may favor its citizens over others. Furthermore, as region citizens are members of the region's political community, they are entitled to benefit specially from region activities - as long as the region does not, in conferring benefits, effectively regulate outsiders or discriminate against nonresidents in ways inimical to national unity, an important qualification.

***Anti-monopoly requirement for BUMD (local government owned enterprise)*.** According to Law 22/1999 (articles 84 and 108) provincial, district and village authorities may own and run public enterprises. There is a major problem, however, because government-

[25] *Parker v. Brown,* 317 U.S. 341 (1943); *Milk Control Bd. v. Eisenberg Farm Prods.,* 306 U.S. 346 (1939).

[26] Fieldwork carried out by David Ray and Rahim Darma, South Sulawesi April 2000

owned enterprises may have monopoly privileges. Even where not so, local governments will seek to protect government-owned enterprises from competition. The decentralization law itself therefore authorizes local activities antithetical to free trade and potentially damaging to national political integration. The only apparent solution to this problem would be a restriction on the ability of local governments either to monopolize a business activity or to legislate discriminatorily in favor of local governmentally owned businesses.

All local government owned enterprises (BUMD) should be prohibited from engaging in monopolistic and other forms of anti-competitive behavior as defined in Law No.5/1999. BUMD should also not be permitted to operate in an anti-competitive and non-transparent manner and should not receive special governmental privileges not otherwise available to private sector firms

II

Taxation and Interregional Trade

With limitations upon local authorities to tax income and assets, and user-benefit taxes[27] becoming fully exploited, domestic trade represents one of the few remaining 'natural' targets for provincial and kabupaten taxes. As shown by the various Persepsi Daerah reports, there was rapid growth in the use of these taxes during the early to mid 1990s, particularly in the transportation of agricultural crops and livestock, resulting in lower prices to producers, and higher consumer prices.[28] (Persepsi Daerah 1999).

As noted earlier, Law 18/1997 significantly reduced the number of trade distorting taxes and levies. Most importantly, provincial and kabupaten authorities were no longer permitted to tax agricultural products involved in inter-regional trade. To offset the loss in fiscal revenue for the regions, the Central Government allowed the collection of land transfer taxes, gasoline taxes, category C mining taxes and use of underground water charges.

However, various reports[29] show there is growing pressure to repeal or at least substantially modify Law 18/1997. Law 18/1997 is perceived to be inconsistent with Law 25/1999 on the devolution of fiscal authority to the regions.[30] The argument is that in the

[27] Charges for using government provided facilities.
[28] Persepsi Daerah 1999.
[29] *'PP Otonomi Daerah diluncurkan 7 Mei 2000'* Bisnis Indonesia, *April 28 2000; 'UU Pajak & Retribusi daerah perlu diubah'*, Bisnis Indonesia *April 11 2000; 'UU Pajak perlu diubah agar Pemda leluasa'*, Bisnis Indonesia *April 18 2000; 'Daerah tunggu PP implementasi UU Otonomi & Perimbangan Keuangan'*, Bisnis Indonesia *May 8 2000.*
[30] The Indonesia Forum has recently weighed into the debate by arguing that UU 18/1997 must be revised or 'perfected' to ensure greater flexibility in revenue raising for local governments. *See* Yayasan Indonesia Forum (2000) *Laporan Hasil Kajian Otonomi Daerah'* presented at the Konperensi Nasional Tentang Otonomi Daerah, President Hotel, Jakarta 9 May 2000.

spirit of decentralization, the authority to impose taxes and levies (*retribusi*) on domestic trade and business activities should be made by local, rather than central government.

Whatever taxation structure emerges out of the decentralization process, it should not be heavily dependent upon the taxation of inter-regional trade. As is the case for many countries, there needs to be the necessary legislation and supporting institutions to prevent tax distortions on domestic trade. A country's constitution perhaps provides the most fundamental means for protecting free trade. In Australia for example, section 92 of the constitution prohibits any forms of duties on internal trade:

> *On the imposition of uniform duties of customs, trade, commerce, and intercourse among the States, whether by means of internal carriage or ocean navigation, shall be absolutely free (Australian Constitution section 92).*

The Indonesian Constitution has no provision that ensures free and open internal trade. As the decentralization process continues and the regions gain more authority, local governments will likely seek to impose taxes on domestic trade unilaterally.[32] For this reason, the MPR should consider amending the Indonesian Constitution to provide for free internal trade and to secure the authority of the national government to override local action injurious to the national economy.

Limiting local government interference with domestic trade is not inconsistent with the local government needs to expand tax revenue. Indonesian local government inclinations to tax trade arises because of restrictions on tax sources and authorities. Local governments are mostly unable to obtain local revenues from taxes on assets, incomes and value added, and this leaves trade as a residual target. And trade is an easy target; officials can exact funds by positioning themselves at key strategic locations, such as at city and district boundaries, weigh stations, ports, bridges, and crossroads. (Note that the more contact local officials have with businesses, traders, and farmers, the more opportunity there is to extract informal or illegal charges (*pungli*).) To reduce incentives to tax trade and to avoid injuring the economy through trade taxation, it may be appropriate to consider devolving other taxation powers (such as property or value added tax) from the center to the regions.

If taxes must be imposed on inter-regional trade (which we stress is clearly a second best outcome), then consideration should be given to two key problems: (1) taxes on through-trade; and (2) discriminatory taxes.

By through-trade, we mean trade passing through a locality or region and having some destination other than the locality or region. If each locality or region through which trade passes has authority to tax it, then there is a likelihood of multiple taxation on the same trade. Multiple taxation, if cumulatively severe, distorts prices, injures consumers and discriminates against producers in distant regions (i.e., those that must transport their produce over long distances). At some point the tax burden may become so great as to cut

[32] Recall the case of Lampung where the Provincial Government has placed an export tax on 180 commodities.

off trade.

Discriminatory taxes on trade arise when regions impose lower tax rates on trade originating in-region than on that originating out of region. Such disparate taxation rates would disadvantage out-of-region trade. For example, sales and transfer taxes imposed on in-region events, such as the delivery or transfer of stocks following sale, that are less for in-region sales than for out-of-region sales would, in effect, impose a penalty on out-of-region sales and discriminate against them.[33]

If taxes on domestic trade are to be allowed, there are ways to protect against such dangers of multiple and discriminatory taxes. Here are some suggestions:

- Enact a national law defining the maximum amount of tax that can be collected by any single jurisdiction (region) on through-trade. Presumably, the tax would be set at a sufficiently low rate so that the sum of cumulative taxes on through-trade would not suppress trade.

- Create a national tax on trade, most likely on the basis of a percentage of value; collect it at a central point; and then apportion it to the regions on the basis of some fair formula.

- Authorize persons to challenge tax exactions before some body that has the authority to review local taxes on trade and decide whether they are consistent with the principle of a free trade union. In cases involving multiple taxation, by different regions, of the same trade, the body could follow a rule such as the following. For the taxation to be lawful, it must be on activity having a substantial connection with the region, be fairly apportioned, not discriminate against interregional commerce, and be fairly related to services the region provides. This test would take into account not only the particular taxation at issue, but also other tax laws, regulations, or practices that together define the actual net effect of the taxation.

- There should be a rule that regions must evenhandedly tax trade originating in-region and out-of-region. Disparate taxation disadvantaging out-of-region trade should be illegal.

Indonesia's national interest would be best served were there no formal taxes on inter-regional trade, as is currently the case. Barring that, Indonesia should seek an equitable and nondiscriminatory means to tax trade, such as suggested above. At a minimum, if the central government chooses to give localities the authority to tax inter-regional trade, such authority should be exercised only under guidelines that minimize the harms such taxes can create.

[33] *Boston Stock Exchange v. Region Tax Comm'n,* 429 U.S. 318 (1977).

III

The *Putra Daerah* Problem: Local Discrimination, Nationhood, and the Rights of Citizens

The concept of citizenship involves more meanings than those contained in issues arising from trade and economic activity. But citizens undertake economic activity – in fact, account for most of it – and an article focused on trade and economic growth must explore the relationship between citizenship, economic activity, and decentralization.

Focusing on trade and neglecting citizenship examines only one variable in a complex equation. In fact, citizenship issues underlie may trade issues, at least insofar as trade issues involve questions of fair and nondiscriminatory treatment. In this sense, citizenship issues are more fundamental than trade issues, because many trade issues depend on them. Trade protective rules might fail if citizenship discriminations or disabilities replace those placed on trade. So we must ask the question – or pose a rendezvous of questions – about the basic rights of Indonesian citizens, both economic and otherwise, wherever they may be in Indonesia. If, as a Javanese or a Batak, I am excluded from some economic activities in Sulawesi, because I am a Javanese or Batak, the country may lose economically.

But rights of citizenship extend beyond being instrumental means to economic integration and growth. They have significant meaning for political integration as well, and economic and political integration go hand in hand. In this sense, citizenship is a carrier of economic and political integration.

Nationhood is not a given; it is built and achieved; and it is an ongoing work of economic, social, and political activity, and may be lost. Indonesia is an archipelagic state and is composed of many territorially based ethnic groups, some with intense religious identities. Local and ethnic identities are powerful; for most Indonesians perhaps more powerful than an Indonesian identity, which may be more a face toward foreign countries than an identification with fellow Indonesians in domestic matters. A nation, however, is made of citizens who identify with it. Local discriminations against citizens from other places deny them this tie with the nation. If, as an Indonesian from Kalimantan, I cannot travel to East Java or Sulawesi and feel accepted on some fundamental level as one who shares with others the common endeavor that is Indonesia, then there is no Indonesia as an overarching identity for me. There must be some reason, other than force, for citizens of Indonesia to identify with the whole of Indonesia. There must be some value to being an Indonesian, throughout the territory of Indonesia, that transcends the accidents of birth, residence, and history.

The fundamental issues are whether all Indonesians, of whatever ethnic, religious, or local origin, endorse an inclusiveness beyond origin and what role the state plays in

[35] This is an important theme to be drawn from the various small business-government forums currently being held by The Asia Foundation in a number of provincial capitals (e.g., Makassar, Medan).

creating and enforcing that inclusiveness. That inclusiveness is a question of what it means to be an Indonesian. The fundamental rights that all citizens possess wherever they may be in the country define what makes them equal and what they share – beyond culture, religion, and history – and create a fundamental connection with the state and fellow citizens.

What are those fundamental rights? We propose here a list of those rights essential to national economic and political integration. There are undoubtedly other fundamental rights the Indonesian Constitution will wish to recognize, but the rights noted here are specially instrumental in securing nationhood and furthering economic development and political integration.

Rights of Indonesian citizen regional non-residents. In the interests of creating national unity there should be some principle that regional governments cannot discriminate against Indonesian citizens, who are regional nonresidents, in matters fundamental to interregional harmony. Local preferences and discriminations can destroy the sense of belonging to a common national enterprise that is a distinguishing sentiment of citizenship. This is particularly true in countries like Indonesia where there are many different ethnic groups and where ethnic and religious conflict is, unfortunately, common. The law must, therefore, impose and defend some strong baseline principal of equality between citizens nor matter what their place of origin within Indonesia.

At a *minimum,* the principle should protect the following protected privileges or rights to:

(1) own, possess, and dispose of property;
(2) engage in gainful employment or business in the private sector;
(3) do business on terms of substantial equality with region citizens;
(4) travel through and within a region, including the right to change residence from one region to another;
(5) be treated equally by justice institutions;
(6) seek medical care.

A region should not be able to treat a non-local citizen different from a local citizen in any of these areas unless the region has a substantial and legitimate reason for the different treatment. In effect, the region should have to show that the non-local citizen is a part of the problem that the region is attempting to solve. For example, a regional law requiring private employers to give local residents a hiring preference discriminates against non-locals in employment and should not stand. On the other hand, a region may be able to charge higher nonresident fees, say for a fishing or hunting license, than it charges residents. In matters of importance, the rights of Indonesians, as citizens of Indonesia, must trump the authority of local governments to favor their own local citizens over other citizens of Indonesia. To do otherwise would only encourage separatist tendencies, injure the economy, and create hostility, conflict, distrust of government, and disbelief in the ability of government to secure the rights of citizens.

A Brief Conclusion

By bringing government closer to the people, decentralization and greater regional autonomy should make government more responsive and accountable. However the effects of decentralization may not always be so propitious. If carried out without limits imposed for the sake of the national economy and political integration, decentralization may result in economic and political balkanization. Indonesia must take care that decentralization proceeds in a carefully crafted framework that anticipates, and resolves, the problems and issues noted in this paper.

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[36] 'Tak Tahan Melayani Pungutan Liar, 200 Sopir Truk di Belawan Mogok' Kompas May 3, 2000, page 1.